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Market Musings

Global Rates, FX & Commodities Strategy

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Sonia Transition: A BOE Nudge

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- In a recent working group paper, the BoE lays out considerations for market participants in relation to the issue, offering, and purchase of Floating Rate Bonds referenced to Libor. This paper follows the recent speech from the FCA chief Andrew Bailey compelling banks to move away from Libor.
- The recent 5y GBP FRN from the EIB is a first step for an issuer and investors to take the transition from Libor to Sonia seriously. Even though the regulatory agencies are nudging market participants in that direction globally, the private market will need to take concrete steps for the transition to proceed.

In its latest working group paper, the BOE pencils down considerations for market participants in relation to the issue, offering and purchase of floating rate bonds (FRNs) referencing Libor. This working paper follows the recent speech from the FCA chief Andrew Bailey compelling banks to move away from the Libor.

The BoE's working paper discuss the risks and suggests certain measures that can be implemented by market participants in this transition phase. We summarize below:

What are some risks with FRNs referenced to Libor?

- **Floating becomes fixed:** If banks are unwilling to submit Libor on a voluntary basis beyond 2021, we could see the FRNs being converted to fixed-rate bonds. The last possible determined rate would then be applied for the remaining life of the bond. This may be unacceptable for both the issuer and investors. From an investor perspective, such issues may become illiquid and may no longer cater to their specific investment needs. From an issuer perspective, those that aim to match liabilities via other instruments may be adversely affected.
- **Liability management:** Discontinuation of Libor would require the legal terms of FRNs to be amended to provide for an alternative floating rate. Any amendments to terms and conditions of the issues will require bondholder consent by way of bondholder meetings. This is not a quick or easy process, involving formal notice periods and (usually) high consent/quorum thresholds to amend terms relating to interest.
- **Hedging arrangements:** Discontinuation of Libor would create an asset-liability mismatch for both the issuer and investor. The associated hedging instruments (e.g. IRS but also potentially cross-currency swaps or other hedging arrangements) may no longer be useful in capturing the rate moves.
- **Other risks around legal and litigation issues.**

What measures can be taken to mitigate these risks?

- **Switching to Sonia:** The most effective way of avoiding risks related to Libor discontinuation in relation to new issues of Sterling bonds would be for new issues of Sterling bonds to reference alternative benchmarks, in particular, SONIA. The recent **EIB GBP FRN (EIB Fires the Starting Gun)** clearly forms a template for transitioning from the Libor to Sonia world. Furthermore, the recent consultations from the BoE also works on developing the "**Term Sonia Reference rates**" in the sterling market.

- **Increased transparency/awareness:** Market participants should make themselves fully aware of the uncertainties around the post-Libor world. It is also appropriate to include detailed risk factors relating to Libor discontinuation debt prospectuses. It may also be prudent to examine how products are labeled and marketed.

- **Alternative fallbacks arrangement:** Terms of long-dated bonds referencing Libor could include an alternative fallback to specifically address discontinuation of a benchmark and attempt to provide the means by which a future replacement benchmark could be applied in specific circumstances. This would not require the consent of bondholders as it would be contemplated within the terms of the bonds themselves.

- **Amending terms of Bond Prospectus:** Issuers could consider varying the bond terms and conditions to facilitate easier amendments to the interest rate provisions for example by applying a **lower bondholder quorum requirement** or consent threshold that might otherwise have applied to this type of amendment. This would facilitate easier amendments to be made to the interest terms, once an alternative benchmark for Libor is established.T

The recent 5y GBP FRN from the EIB is a first step for an issuer and investors to take the transition from Libor to Sonia seriously. Even though the regulatory agencies are nudging market participants in that direction globally, the private market will need to take concrete steps for the transition to proceed. Stay tuned.

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